Fin 5433: Chapter 21

Real Estate Investment Trusts REIT's

Note: Some of the material in this presentation is from Chapter 24 of:
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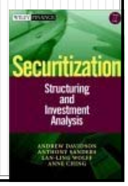
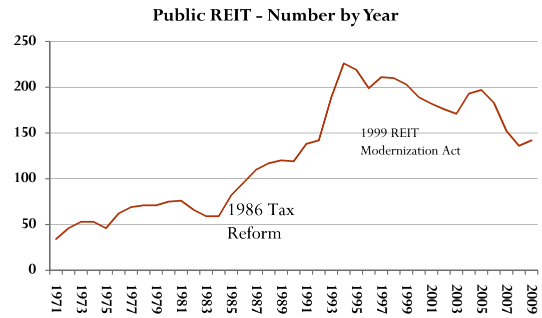
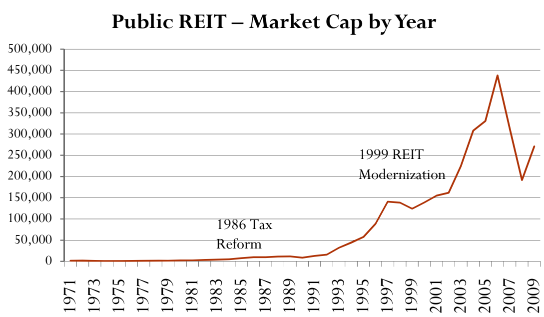


Number of Public REITs by Year



Market Cap of REIT's (Public, $Million))



The 10 Largest REITs by market cap

(Jan 31, 2010, Vanguard REIT Index Fund)

- 1 Simon Property Group Inc.
- 2 Vornado Realty Trust
- 3 Public Storage
- 4 Boston Properties Inc.
- 5 Equity Residential
- 6 HCP Inc.
- 7 Ventas Inc.
- 8 Host Hotels & Resorts Inc.
- 9 AvalonBay Communities Inc.
- 10 ProLogis
- Ten largest holdings = 43.1% of total net assets (98 firms total)

REITs

- Are a securitized way to hold RE
- REITs often own real property (e.g., shopping center, hotels and office buildings) so shareholders in the REIT receive a share in the operating cash flows to the REIT as well as capital appreciation when properties are sold.
- REITs may own mortgages rather than properties
- A hybrid REIT owns both
- REITs may specialize in certain types of CRE

REITs

- Real estate investment trusts (or REITs) are essentially closed-end funds that hold real estate in their portfolios instead of stocks and bonds.
- They were originally conceived to offer a passive way to invest in real estate and were not directly involved in the management of the CRE.
- With the 1986 tax law changes REITs were allowed to manage their properties rather than hiring outside managers.
- The vast majority of today's equity REITs are self-advised, vertically integrated operating companies. They actively manage their portfolios to grow cash flows and their portfolios.

A Closer Look at Real Estate Investment Trusts (REIT)

REITs are a corporate form of ownership engaged in real estate investment, that do not pay federal taxes at the corporate level.

- **REITs invest primarily in real property and mortgages.**
- A REIT is a trust legally established to raise capital from investors (in the form of common stock and bond issuance) and may borrow from lenders in order to buy income-producing properties or a REIT may make mortgage loans in varying maturities.

Qualifying as a REIT

- A REIT is allowed a special tax status; that is, it is only taxed at corporate rates on its retained earnings (annual) if it meets the following general conditions:

(1) A REIT is legally required to pay virtually all of its taxable income (90 percent) to its shareholders every year.

(2) A REIT's assets are primarily composed of real estate assets held for the long term (real property or mortgages),

(3) A REIT's income is mainly derived from real estate,

UPREIT - Umbrella Partnership REIT

- In an UPREIT structure, the partners of the existing partnerships and a newly-formed REIT become partners in a new partnership which is termed "The Operating Partnership."
- The partners contribute the properties from the existing partnership and the REIT contributes the cash proceeds from its public offering.
- Typically, the REIT is the general partner and the majority owner of the Operating Partnership Units.

Real Estate Investment Trusts (REITs)

- ***Primary Advantages:***
  - **REITs are not subject to double taxation**
  - **limited liability to shareholders**
  - **REITs allow investors liquidity and diversification**
- ***Primary Disadvantages:***
  - **income to shareholders is portfolio income**
  - **tax losses do not pass through to the shareholders**
  - **REITs must meet substantial operating restrictions**

REIT Investor Taxation

- ***Example – Unitholder Tax Calculation***

Jennifer decides to invest in an REIT that is currently trading at $20 per unit. The REIT has funds from operations of $2 per unit and distributes 90%, or $1.80, of this to the unitholders. However, $0.60 per unit of this dividend comes from depreciation and other expenses and is considered a nontaxable return of capital. Therefore, only $1.20 ($1.80 - $0.60) of this dividend comes from actual earnings.

This amount will be taxable to Jennifer as ordinary income, with her cost basis reduced by $0.60 to $19.40 per unit. As stated previously, this reduction in basis will be taxed as either a long- or short-term gain/loss when the units are sold.

(From - http://www.investopedia.com/articles/pf/08/reit-tax.asp)

Simon Property Group

	2008	2007	2006
Total dividends paid per common share	3.60	3.36	3.04
Percent taxable as ordinary income	84.7	92.9	81.4
Percent taxable as long-term capital gains	1.2	7.1	18.6
Percent nontaxable as return of capital	14.1	0.0	0.0
	100.0	100.0	100.0

Real Estate Investment Trusts

- Equity Trusts
  - Specializations
    - Property Type – Office, Retail, Residential, Healthcare, Hospitality, Industrial
    - Trust Duration – Most now infinite lives
  - Investment Appeal
    - Diversified Portfolio – The REIT has diversity, plus its easy for investors to include additional REITs and other investments to achieve a broad portfolio
    - Liquidity – trades like other stocks

REIT Index Market CAP 1/31/2010

	Vanguard	MSCI US REIT Index
Diversified REITs	8.80%	8.80%
Industrial REITs	5.90%	5.90%
Office REITs	17.50%	17.50%
Residential REITs	15.30%	15.30%
Retail REITs	24.90%	24.90%
Specialized REITs	27.60%	27.70%

Specialized may include prisons, theaters, golf courses, cellular towers and timberland

Equity Trusts - Caveats

- Purchase of original property may not be arm's length
- Potential for conflicts of interest (UPREIT unit values for example)
- Safeguards
  - Appraisals to ensure not over paying for property
  - Sarbanes-Oxley requirements for publicly traded companies

Private REITs

- Targeted to institutional investors
- Syndicated to investors
  - Syndicated REITs may be expensive (10% skimmed off the top for marketing etc. before property investments made) and less liquid
- Incubator REITs – while getting a track record before going public

FFO

- In 1991, NAREIT adopted a definition of **Funds From Operations (FFO)** in order to promote a supplemental industry-wide standard measure of REIT operating performance that would not have certain drawbacks associated with net income under generally accepted accounting principles ("GAAP"). The definition was clarified in 1995, 1999 and 2002. The current definition follows:
- FUNDS FROM OPERATIONS means net income (computed in accordance with generally accepted accounting principles), excluding gains (or losses) from sales of property, plus depreciation and amortization, and after adjustments for unconsolidated partnerships and joint ventures. Adjustments for unconsolidated partnerships and joint ventures will be calculated to reflect funds from operations on the same basis.

NAREIT goes on to say . . .

- Historical cost accounting for real estate assets implicitly assumes that the value of real estate assets diminishes predictably over time. Since real estate values instead have historically risen or fallen with market conditions, many industry investors have considered presentations of operating results for real estate companies that use historical cost accounting to be insufficient by themselves.
- The term Funds From Operations was created to address this problem. It was intended to be a standard supplemental measure of REIT operating performance that excluded historical cost depreciation from — or "added it back" to — GAAP net income.

Funds from Operations (FFO)

- FFO is not GAAP but considered a useful tool for valuing and comparing REITs
- Considers "uniqueness" of REITs due to depreciation and the effect on income and cash flows from buying or selling properties

FFO (Funds From Operations)

	Income Statement	FFO calc
Rent	100	100
- Operating Expenses	40	40
Net Operating Income	60	60
-Depreciation	40	
+ Gains on sale of property	20	
Net Income	40	
Cash Flow		60
EPS (10 shares outstanding)	4	
FFO per share		6

REIT Analysis –further adjustments

- Cash Available for Distribution (CAD).
  - CAD is a measure of the REIT's ability to generate cash and to distribute dividends to its shareholders. CAD is derived by subtracting nonrecurring expenditures.
- Adjusted Funds From Operations (AFFO).
  - AFFO refers to a further adjustment by subtracting from Funds from Operations (FFO) both (1) normalized recurring expenditures that are capitalized by the REIT and then amortized (example paint every 3 years, carpet every 5 year), but which are necessary to maintain a REIT's properties and its revenue stream and (2) "straight-lining" of rents (straightlining averages the tenant's rent payments over the life of the lease).

REIT Expansion and Growth

- Low retained earnings
  - 90% of net income distributed so retained earnings are not the engine for growth
  - However, the depreciation can be reinvested so it acts like the retained earnings
- Follow on Stock Offering
  - Concern for dilution of original stockholders
- Debt Financing
  - Limited by capital markets

Growing Income

- Existing Properties
  - Rental Income – higher occupancy or more efficient management
  - Redevelopment – upgrading of property
- Acquisitions
  - Purchase properties when the returns on the property are high compared to cost of capital (including debt)
  - Swap REIT stock for property interests

Growing Income

- Development – may have existing land that can be developed (expansion of industrial parks for example)
- Provision of Services
  - Property management or development for third parties
  - Credit card operations for mall tenants
  - These may be done through taxable REIT subsidaries
- Financial Engineering
  - Improve financing terms and lower capital costs (simple example – refinance to a lower interest rate)

Additional Issues in REIT analysis

- Tenant improvements & free rent
- Leasing commissions & costs
- Straight-line rents
- Income from managing other properties
- Types of mortgage debt
- Ground leases

See textbook for details on these

Additional Issues in REIT analysis

- Lease term and renewal options
- Occupancy numbers:
  - Occupied (now paying rent) & leased space (signed lease, with payments starting in future)
- Retail REITs: Sales per square foot
- Costs of being a public company
- Sarbanes-Oxley

See textbook for details on these

Mortgage REITs

- Does not own property; owns mortgage paper
- Started as a source of development capital not subject to banking regulations
- Rates tended to be higher than bank rates
- May have to borrow money from banks to provide to developers
- More recently were buyers of B paper of CMBS to get higher yields